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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 4541

JOSEPH B. FLEMING AND AARON COLNON, TRUSTEES OF THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY, ET AL.,

Petitioners,

vs.

JOHN C. TRAPHAGEN, JAMES E. GOWEN, GEORGE H. WILSON AND CHARLES G. WOODWARD, CONSTITUTING THE PROTECTIVE COMMITTEE FOR HOLDERS OF CHOCTAW AND MEMPHIS RAILROAD COMPANY FIRST MORTGAGE 5% GOLD BONDS, DUE JANUARY 1, 1949,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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THE BLAKELY-WALKER PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioners respectfully show:

Summary Statement of the Matter Involved.

This is a proceeding for the reorganization of a railroad under Section 77 of the Bankruptcy Act (11 U. S. C. A. § 205). The principal debtor, The Chicago, Rock Island

and Pacific Railway Company, filed a petition for reorganization on June 7, 1933 with the District Court of the United States for the Northern District of Illinois. On October 24, 1933, Choctaw, Oklahoma and Gulf R. Co., a wholly owned subsidiary, filed its petition in the same proceeding. (R. 14.) A portion of the C. O. & G. railroad consists of 280 miles of line in Arkansas which it purchased in 1900 from Choctaw & Memphis R. Co. (now defunct); said line was acquired subject to the lien of the Choctaw & Memphis First Mortgage securing $3,524,000 principal amount of 5% bonds maturing January 1, 1949 (R. 13); the mortgage was assumed by the C. O. & G. The text of the mortgage appears at R. pp. 61-88. The interest coupons are payable semi-annually in New York or Philadelphia on January 1 and July 1 in each year. (R. 63.) The coupon due January 1, 1934 was paid by order of court on February 5, 1935. (R. 38.) No later interest coupons were paid prior to the date of approval by the court of the plan of reorganization, June 15, 1945. (R. 189.) Subsequently, on August 20, 1945, the Trustees asked leave of court to make certain cash distributions provided for in the plan, including $1,762,000 representing accrued and unpaid interest on the C&M bonds to January 1, 1944, the effective date of the plan (R. 222); the court authorized such cash distribution, and the same was made accordingly.

The fundamental question here is whether the Choctaw & Memphis bondholders are entitled to recover interest on the interest represented by the coupons after their respective dates of maturity. No other bond issue in this proceeding has been allowed interest on interest, notwithstanding the coupon interest was fully earned by some of the mortgage divisions and was not paid on the due dates. See *In re Chicago, Rock Island and Pacific Ry. Co.*, 50 Fed. Supp., pp. 849-850.

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Pursuant to sub-section (c)(10) of Section 77, the court approved a formula for segregation of revenues and expenses to mortgage divisions and ordered it to be applied for each six months' period beginning January 1, 1936 and ending December 31, 1937. (R. 49, 56.) The formula assumes that the various mortgage divisions are independent, separately operated railroads, and attempts to ascertain the revenues obtained and expenses incurred by each. As appears from the first opinion of the District Court, reported 50 Fed. Supp. 835, 846, the Commission made certain adjustments in both 1936 and 1937 earnings as ascertained by application of the formula, and used the adjusted formula results in making allocations of the several classes of new securities under the plan. The adjusted formula results for the test periods in question showed the average annual adjusted income of the Choctaw & Memphis mortgage division to be $425,093*, and of the remainder of the C. O. & G. estate to be a deficit of $165,299*, or an average annual net income for the estate as an entirety of $259,794. The annual interest accruals on the C&M bonds amounted to $176,200.

The plan of reorganization of July 31, 1941, provided that the lien of the C&M bonds should be preserved and their maturity date extended from January 1, 1949 to January 1, 1969, with the annual interest rate reduced from 5 per cent to 4 per cent; that for the accrued and unpaid interest, the bondholders should receive an equal face amount of new first mortgage bonds of the reorganized company. (R. 128.) By supplemental order, the Commission modified the plan by providing that the accrued and unpaid interest be paid in cash. (R. 164-165.)

* See Schedule A, Chicago, Rock Island and Pacific Ry. Co. Reorganization, 252 I. C. C. at p. 489, lines 28, 29 and 30. This is Item No. 31 of Appellants' Designation of Record and was omitted in printing by stipulation. (R. 236.)

The plan of reorganization, approved June 15, 1945, contained the following provision (R. 166):

"XXII. Construction of Plan.

"The construction of the plan by the court shall be final and conclusive. The court may correct any defect, supply any omission, or reconcile any inconsistency in such manner and to such extent as may be necessary or expedient in order to carry out the plan effectively."

Pursuant to this authority, the district court corrected the plan in respect of its provisions relating to the C&M bonds as follows (R. 193-194):

"8. Under the terms of the plan, it is provided, 'That the construction of the plan by the Court shall be final and conclusive. The Court may correct any defect, supply any omission or reconcile any inconsistency in such manner and to such extent as may be necessary or expedient in order to carry out the plan effectively.' The Court finds that the following correction should be made for the reasons stated in the opinion* of the Court filed herein on May 14, 1945.

"The following paragraph contained in the supplemental order of the Commission dated May 1, 1944 which reads:

" 'The Choctaw & Memphis Railroad Company first mortgage, dated January 2, 1899, will be assumed by the reorganized company, and the $3,524,000 of 5-percent bonds issued thereunder and outstanding in the hands of the public shall remain outstanding as an obligation of the reorganized company after such bonds have been presented for stamping with a legend showing that the maturity date thereof has been extended to January 1, 1969, and that the bond interest rate thereon has been reduced to 4 per cent per annum with respect to the installments of interest fall-

* See, R. 164-166.

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ing due subsequent to January 1, 1944, and in the case of bonds in coupon form for the attachment of additional coupons for interest during the extension period. For the $1,762,000 of unpaid accrued interest the holders of the bonds shall receive cash, as hereinafter stated.'

should be corrected by substituting the following therefor:

"'The Choctaw & Memphis Railroad Company first mortgage dated January 2, 1899, and the $3,524,000 of 5-percent bonds issued thereunder and outstanding in the hands of the public shall remain undisturbed and unaffected by the plan, with preservation of lien and rights of bondholders as set forth in said mortgage and said bonds. For the $1,762,000 of unpaid accrued interest to January 1, 1944, the holders of the bonds shall receive cash, as hereinafter stated.'

"All provisions of the plan inconsistent with the foregoing correction should be corrected to conform therewith."

The plan provides that the allowance of interest on interest on the C&M bonds should be determined by the court. (R. 128.) On May 11, 1945, the District Court handed down an opinion denying the request for interest upon interest (R. 156-158) and entered its findings, conclusions and decree relative thereto on June 14, 1945. (R. 172-174.) Finding No. 2 was:

"that neither the Choctaw & Memphis Railroad Company mortgage dated January 2, 1899, nor the bonds secured thereby, contain any covenant or other provision for the payment of interest on matured and unpaid installments of interest."

The conclusions were:

"1. The Court has jurisdiction of the subject-matter, of the property upon which said first mortgage of said Choctaw & Memphis Railroad Company and

the bonds secured thereby are a lien, and of the holders of the bonds issued and outstanding under said mortgage.

"2. Said bondholders have no contract right to receive payment of interest on matured and unpaid installments of interest on said bonds, and have no claim in equity thereto by virtue of any facts or circumstances shown by the record in these proceedings."

Respondents appealed from the order of June 14, 1945 to the Circuit Court of Appeals for the Seventh Circuit. (R. 174-175.) Of the contested issues, respondents (appellants below) withdrew all except that one involving the question whether, under the facts of record, the holders of the C&M bonds are entitled in law and in equity to receive interest on interest on matured and unpaid interest coupons from the respective maturity dates thereof to the date of payment. The Circuit Court of Appeals reversed the judgment of the District Court, holding that it was error to refuse to allow and order paid simple interest on the coupons after their respective dates of maturity. The *ratio decidendi* is found in the following statements in the opinion:

"In the reorganization plan, confirmed by the District Court and now in process of consummation, the court directed that the C. & M. bonds should not be affected by the reorganization, a conclusion inspired undoubtedly by the fact that it is undisputed that these bonds are adequately secured and that the annual earnings properly allocable to the division upon which they are a lien exceeds substantially the interest requirements. It follows from the District Court's findings and judgment that the bonds of the C. & M. are no part of the reorganization, in no wise affected by it, and, so far as rights and remedies are concerned, occupy the same position they would have had there been no bankruptcy." (R. 246.)

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"* * * appellants are not a part of the plan and have no part in the reorganization but constitute prior parties in interest who, the court has expressly found, are fully secured, and, therefore, shall not be affected by the plan and whose security shall remain unaffected by it." (R. 252.)

According to respondents' calculations, after giving effect to the $1,762,000 interest payment made in October, 1945, the interest on interest at the rate of 6% per annum, in accordance with Pennsylvania law, amounts to approximately $225 per $1000, or a total of $793,000, as of January 1, 1946 (subject to slight downward revision by reason of the $1,762,000 interest paid in October 1945).

Statute Involved.

The pertinent provisions of Section 77 of the Bankruptcy Act (11 U. S. C. A. Section 205) are reproduced as an appendix, *infra*, page 29.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 17, 1946. (R. 253.) The jurisdiction of this court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. §347), and Section 24(c) of the Bankruptcy Act.

Questions Presented.

1. Whether the Choctaw & Memphis bonds are not a part of the plan and have no part in the reorganization and the rights and remedies pertaining thereto occupy the same position as if there were no bankruptcy of Choctaw, Oklahoma and Gulf R. Co., debtor?

2. Whether, if said bonds be a part of the reorganization and within the plan, the holders thereof are entitled under the law applicable to bankruptcy proceedings to an allowance of interest on interest accrued during the period of administration?

3. Whether, if interest on interest is allowable, the rate thereof is governed by the law of Pennsylvania, one of the states where the coupons are optionally payable?

4. Whether such interest on interest, if allowed, constitutes only a general, unsecured claim, where the mortgage does not provide for interest on arrears of interest and in terms secures only the payment of principal and interest thereon?

Reasons Relied on for the Allowance of the Writ.

1. The Circuit Court of Appeals has decided important questions of federal law which have not been but should be settled by this Court, namely:

(a) Where bonds are an obligation, and constitute a lien upon the property, of a debtor in a reorganization proceeding under Section 77, do said bonds cease to be a part of the reorganization and a part of the plan because the plan contains the same provisions for security and payment of principal and interest as are contained in the mortgage?

(b) Where the net earnings of a mortgage division exceed the amount of interest accrued on the mortgage indebtedness for any period during the bankruptcy administration, are the bondholders thereby entitled as of right to be paid such accrued interest on the due date regardless of whether the net earnings of the debtor's entire estate are sufficient for the operating, maintenance and other necessary expenses of the entire estate?

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(c) Is it consistent with the "fair and equitable treatment" required by sub-section (e) of Section 77 for bondholders to be compensated for the delay in payment of their interest installments when other secured creditors with at least equal basis of claim therefor receive no such compensation?

(d) Is it consistent with the provisions of Section 77 to require a claim for interest on interest to be discharged in cash where such interest on interest is not secured by the terms of the mortgage, the effect of such cash payment being to prefer the unsecured claim over secured creditors of the same debtor?

2. The Circuit Court of Appeals has decided a federal question in a way that is probably in conflict with an applicable decision of this court, namely, *Prudence Corporation* v. *Geist*, 316 U. S. 89, 95, which holds that the Bankruptcy Act prescribes its own criteria for distribution to creditors and that federal not local law (Pennsylvania law in the instant case) applies.

WHEREFORE, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Honorable Court directed to the Circuit Court of Appeals for the Seventh Circuit, commanding that Court to certify and send to this Court for its review and determination, on a date certain to be therein named, a full and complete transcript of the record and the proceedings in the cases numbered and entitled on its docket Nos. 8928 and 8946, Consolidated Appeals, "John C. Traphagen, *et al.*, appellants, *vs.* Joseph B. Fleming and Aaron Colnon, as Trustees of The Chicago, Rock Island and Pacific Railway Company, *et al.*, appellees", to the end that said cases be reviewed and determined by this Court, and that the judgment herein of said Circuit Court of Appeals be re-

versed; and that your petitioners may have such other and further relief in the premises as to this Court may seem proper.

Chicago, Illinois.

Dated August ____, 1946.

Respectfully submitted,

W. F. Peter and
Otis F. Glenn,
Attorneys for Petitioners, Joseph B. Fleming and Aaron Colnon, Trustees of The Chicago, Rock Island and Pacific Railway Company,
1025 La Salle Street Station,
Chicago, Illinois.

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Respondents.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions Below.

The opinion of the Circuit Court of Appeals (R. 245) is reported in 155 Fed. (2) 889. The opinion of the District Court (R. 156-158) is not reported.

Jurisdiction.

A statement of the jurisdiction is given in the petition (p. 7), and, to avoid duplication, is not repeated here.

Statement of the Case.

A statement of the case is set forth in the petition under the heading "Summary Statement of the Matter Involved" and, to avoid duplication, is not repeated.

Specification of Errors.

The Circuit Court of Appeals erred

1. In holding that the Choctaw & Memphis bonds are not a part of the plan and have no part in the reorganization and that the rights and remedies of the bondholders occupy the same position they would have if there had been no bankruptcy proceeding.

2. In holding that the holders of Choctaw & Memphis bonds are entitled to an allowance of interest on interest accrued on their bonds during the period of bankruptcy administration because the net earnings of their mortgage division exceeded the interest requirements, but without regard to whether the net earnings of the debtor's entire estate are sufficient to pay such interest as and when it becomes due consistently with the funds needed for working capital, operation, maintenance, etc., of the debtor's entire estate.

3. In holding that the allowance of interest on interest and the rate thereof are governed by the local law of the State of Pennsylvania, wherein the coupons are optionally payable.

4. In holding that the claim of the Choctaw & Memphis bondholders for interest on interest should be paid in cash instead of holding that such claim is only a general unsecured claim against the debtor's estate.

SUMMARY OF ARGUMENT.

I.

The opinion of the Circuit Court of Appeals proceeds upon the theory that by virtue of the findings and judgment of the District Court, the Choctaw & Memphis bonds are not a part of the reorganization or a part of the plan and therefore their rights and remedies occupy the same position as if there had been no bankruptcy, *i. e.*, their rights are the same as would obtain between a solvent debtor and his creditor. This theory is erroneous.

The railroad upon which the C&M bonds are a lien remains in the jurisdiction of the District Court as part of the estate of the CO&G and it is being operated by the Trustees under control of the court. Under Section 77, the rights of creditors and the satisfaction of their claims must be worked out through the medium of a plan of reorganization; it is a legal impossibility for the C&M bondholders to have any status as such outside of the reorganization proceeding or to receive anything of value on account of their bonds except under a plan. The fact that the plan, as corrected, gives them the same treatment as does the mortgage, simply means that the plan adopts the mortgage provisions; but what the bondholders receive is pursuant to the plan and not the mortgage.

The Court of Appeals misconceived the intent and purpose of the provisions of the plan as corrected by the District Court. When the District Judge corrected the plan so as to leave the Choctaw & Memphis bonds undisturbed, not affected by the plan in any way (R. 165), he was using the words "not affected" in the technical sense

of that expression as contained in sub-section (e) of Section 77 which provides that the plan need not be submitted to any class of creditors in the event of a finding that such class will not be adversely and materially affected by the plan. That a class of creditors may not be affected by the plan does not mean that they are not a part of the plan or are out of the reorganization proceeding.

II.

Respondents' demand assumes that the net earnings of the C&M mortgage division were at all times in excess of annual interest requirements. The only evidence of net earnings is the figures obtained by applying the court-approved formula to the operations of the several mortgage divisions of the system for the years 1936 and 1937. The purpose of this formula was to ascertain *relative* earning power as a basis for allocating to the several classes of creditors the aggregate amount of new securities to be issued under the plan. The earnings of any mortgage division for any prior or subsequent year were never determined; and hence it cannot be known whether the C&M mortgage division produced net earnings, outside of the test period, sufficient to meet interest requirements. Even for the test period, the average net annual earnings of the CO&G estate were such that had the C&M bond interest been paid, only $85,594 would have been left, an amount inadequate for the needs of a 1000-mile railroad.

Respondents claim interest on interest as "compensation for the delay in payment of their interest". But pending the preparation and certification of a reorganization plan, no one could foretell what treatment would be provided for the C&M bonds; payment of interest in the interim might prove to be inconsistent with the plan when pro-

mulgated; the non-payment was a necessary feature of the reorganization process. The fact that the later war earnings of the Trustees made it possible to pay the entire arrears of C&M bond interest does not create a constructive and retroactive obligation to make payment of the interest on the maturity dates in the prior years. The Trustees having been under no obligation to pay the interest as it matured, they are under no obligation to compensate the bondholders for such non-payment.

The alleged principle that interest, if wholly earned, must be paid when due would be equally applicable to a payment *pro tanto*, to bondholders whose interest is partially earned. The result of all such compelled payments would be to deplete Trustees' cash to an extent that might impair their ability to carry on operations.

III.

The Bankruptcy Act prescribes its own criteria for distribution to creditors; the federal, not local, law applies. The Court below, in holding that the right of the bondholders to receive interest on the coupons after their maturity is determined by the law of the State of Pennsylvania wherein the coupons are optionally payable, was following its theory that the bonds are not a part of the reorganization and not a part of the plan. As shown under Point I, this theory is erroneous. Under the federal law of bankruptcy which governs, the bondholders are not entitled to interest on interest.

IV.

The C&M Mortgage secures only the principal and simple interest on the bonds. The Sequestration Order of the District Court (R. 20) does not extend the scope of the lien given by the mortgage. The right to interest on interest, if such right exists, is not a secured claim, and if that claim were to be recognized at all, it would constitute only a general claim against the Chicago, Oklahoma and Gulf estate.

ARGUMENT.

I.

The Choctaw & Memphis Bonds Are Still a Part of the Plan and of the Reorganization Proceedings.

The plan which the Commission certified to the District Court altered the C&M mortgage and bonds in two particulars:

(1) The maturity date was extended for 20 years.

(2) The interest rate was reduced from 5% to 4%.

The court corrected the plan by striking out these alterations and providing in lieu that the bondholders should receive their principal on January 1, 1949 with interest at 5% per annum. The fact that the rights thus provided for the bondholders were coincident with their contract rights under the mortgage does not mean that the plan ceased to operate on them. Their right to receive principal and interest springs from the plan and not the mortgage; the debtor is incapable of performing the mortgage contract. The obligation of the reorganized company to pay the principal and interest on the C&M bonds will arise by virtue of the final decree in the proceeding pursuant to subsection (f) of Section 77, which provides that the property transferred and conveyed to the debtor or to the corporation provided for by the plan "shall be free and clear of all claims of the debtor, its stockholders and *creditors*, and *the debtor shall be discharged from its debts and liabilities*, except such as may consistently *with the provisions of the plan* be reserved in the order confirming the plan or directing such transfer and conveyance," etc. Thus the reorganized company will acquire

the C&M mortgage division free and clear of all claims of creditors except those imposed upon it by the provisions of the plan; the debtor, the CO&G, will be discharged from its debts and liabilities. The reorganized company is not required to assume the C&M bonds. In order to receive their interest to, and their principal on, January 1, 1949, the C&M bonds must be within the plan.

As corrected by the court, the plan reads:

> "The Choctaw & Memphis Railroad Company first mortgage dated January 2, 1899, and the $3,524,000 of 5 per cent bonds issued thereunder and outstanding in the hands of the public shall remain undisturbed and unaffected by the plan, with preservation of lien and rights of bondholders as set forth in said mortgage and said bonds. For the $1,762,000 of unpaid accrued interest to January 1, 1944, the holders of the bonds shall receive cash, as hereinafter stated." (R. 194.)

This substitution could not have put the C&M bonds out of the plan; the very $1,762,000 of back interest which the bondholders later received in October, 1945, was paid pursuant to the foregoing provision.

It would be anomalous to hold that any alteration, however slight, in the contract rights of a creditor leaves him within the plan, but that if no alteration is made, he is, *ipso facto*, without the ambit of the plan. Whatever the creditor receives, whether the equivalent of his contract rights or otherwise, is received by virtue of the plan itself and not the contract.

Section 77(b) provides:

> "The term 'creditors' shall include, for all purposes of this section, all holders of claims of whatever character against the debtor or its property, * * * The term 'claims' includes debts whether liquidated or unliquidated * * * liens, or other interests of whatever character."

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Subsection (c) (7) provides:

> "The judge shall promptly determine and fix a reasonable time within which the claims of creditors may be filed or evidenced and after which no claim not so filed or evidenced may participate except on order for cause shown * * *"

The legislative intent of the foregoing is plain; the rights of the creditors and the satisfaction of their claims are to be worked out through the medium of a plan of reorganization.

The Choctaw & Memphis mortgage division is still in the custody of the District Court; the Trustees have the legal title thereto, and are carrying on the business of the debtor under the control of the court. This state of affairs will continue until the reorganization proceeding terminates. In its order of June 14, 1945, the District Court properly concluded that it had jurisdiction of the property upon which the C&M mortgage and bonds are a lien "and of the holders of the bonds secured and outstanding under said mortgage". (R. 173.)

The Circuit Court of Appeals has misinterpreted the purpose and effect of the correction made by the District Court in the plan. When the District Judge stated in his opinion (R. 165)

> "In other words, the Choctaw & Memphis bondholders would benefit to a greater degree under the plan than if their legal rights remained unaffected,"

he meant "under the plan" of the Commission. The antithesis is between the Commission's plan and the plan as corrected by the court. And when the judge said (R. 165)

> "The court concludes that the proper solution is to leave the Choctaw & Memphis bonds undisturbed, not affected by the plan in any way",

he was using the words "not affected" as they are found

and used in Section 77(e) and in compliance with its requirements:

> "*Provided Further,* That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, * * *"

For the same reason and purpose, the court made the following conclusion in its order of June 15, 1945 approving the plan (R. 196):

> "3. The interests of the holders of the Choctaw & Memphis Railroad Company First Mortgage Bonds will not be affected by the plan, as corrected. If the Commission finds that the interests of such class of creditors will not be adversely and materially affected by the plan, submission to such class shall not be necessary."

If any creditor is "not materially affected" by a plan, it is because the plan substantially recognizes his contract rights without alteration. But Congress did not provide that such creditor was thereby excluded from the plan, but simply that he might be excluded from voting on it.

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II.

An Allowance of Interest on Interest Accrued During the Period of the Bankruptcy Administration Is Inconsistent With the Provisions and Intent of Section 77. That the Net Earnings of the C&M Mortgage Division Exceeded Interest Requirements Does Not Justify Such Allowance; the Net Earnings of the Entire Estate and Their Adequacy to Provide the Necessary Funds for Proper Operation and Maintenance of the Debtor's Railroad Must Be Considered.

Respondents' demand is fundamentally based on their claim that the net earnings of the C&M mortgage division as revealed by the formula* were in excess of the annual interest requirements on the bonds.

The purpose of a formula, as disclosed by subsection (c), par. (10) under the authority of which it was established and applied, is to ascertain the relative earning power and the values resulting therefrom of the several mortgage divisions. Here, the formula was required to be applied for only two years, 1936 and 1937; these constituted a test period. The Commission used the formula results as the basis of its allocations of certain of the new securities provided for in the plan; 252 I. C. C. 483, 484. The formula was applied to the operations of all of the mortgage divisions of the Rock Island system for the test period. Whether the earnings of the system as a whole for 1936 and 1937 were higher or lower than those of prior or later years was not material; the *relative* earnings of the mortgage divisions were revealed and the premise was that

* The formula for segregation of earnings of August 16, 1934 (R. 30-31) was never approved by the court. The only formula ever so approved was that of June 4, 1937 (R. 49-51) and later modified. (R. 56-57.) See 50 Fed. Supp. 844-845.

this relationship would be more or less constant from year to year. All that the record shows then is that the Choctaw & Memphis mortgage division had average annual net earnings, as adjusted, for the test period of $425,093, being $248,893 in excess of annual interest requirements. What its net earnings were for any other period during bankruptcy administration is unknown.

In their brief below, respondents characterized their claim for interest on interest as "compensation for the delay in payment of their interest installments". The delay in payment did not destroy the right to the interest; each six months' accrual increased the amount of the claim. But the right to be *paid* interest on the due date is another matter; the covenant to pay was the debtor's, not the Trustees'. The Trustees committed no breach of covenant in not paying the coupons at maturity. No plan of reorganization was certified to the court until August, 1941; until then, no one could foresee what treatment would be therein provided for the C&M bonds; they might receive new securities in whole or partial satisfaction of their aggregate claim for principal and accrued interest, or the bonds might be extended and the accrued interest satisfied in new securities (as was provided in the original plan) or in cash (as in the modified plan). Absent the right of receiving, and the Trustees' correlative duty of paying, interest on the due dates, there is no basis for claiming compensation for delay. The fact is that the delay was a necessary ingredient of the reorganization process.

Furthermore, the unexpressed premise behind the claim for interest on interest, *i.e.*, that funds for paying the several coupons as they matured were available from the net earnings of the C&M mortgage division, is not supported by any evidence. The 2 year test period results

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are adequate for the determination of relative values and allocation of new securities; they are insufficient to base a demand for actual cash payment of interest on each six months' maturity date during a 10-year period. And even for the test period, the average annual earnings of the CO&G estate as an entirety were only $259,794. Payment of C&M bond interest would have left only $83,594 as working capital of a 1000-mile railroad—plainly inadequate.

The large earnings of the war years made it possible for the Commission to provide in its modified plan of May 1, 1944 for a cash distribution among the various classes of creditors of $34,279,750 (R. 221) which included the $1,762,000 for all arrears of interest on the C&M bonds to January 1, 1944, the plan's effective date. But we submit that the Trustees' financial ability to pay *nunc pro tunc* does not operate retroactively to create a constructive obligation to make the payment on the maturity dates in the prior years, and to create a corresponding obligation to compensate the bondholders for that constructive failure.

The table appearing in 257 I.C.C. p. 290 gives the amount of accrued and unpaid interest on the various classes of bonds as of January 1, 1944. The table in 252 I.C.C. pp. 488-489, shows that during the test period other mortgage divisions earned their interest in part. Certainly, if C&M bondholders had the right to immediate payment of all their interest because all was earned, by parity of reasoning other bondholders whose interest was earned in part became entitled to immediate payment *pro tanto*. For surely the alleged right to immediate payment is not an "all or nothing" right. Surely a bondholder whose mortgage division earned only 90% of interest requirements should not go empty handed, while another creditor gets paid because his mortgage division made the full 100%. But if the right to immediate payment must be

thus generally recognized and payment made accordingly, the inevitable result is that the estates would be so stripped of cash as to seriously impair the Trustees' ability to carry on operations and give adequate common carrier service.

In this connection, it is necessary to revert to the theory of the Circuit Court of Appeals that the C&M bondholders are not a part of the plan and have no part in the reorganization as a result of the corrections made to the plan by the District Judge. Even on that theory, the bondholders' status *de hors* the plan cannot be related back *ab initio*. They were certainly in the reorganization and within the plan until the correction was made; and while they were in the reorganization, they were subject to the applicable provisions of the Bankruptcy Act. The Court fell into error in holding that as a result of the findings and judgment of the District Court, the rights and remedies of the C&M bondholders "occupy the same position they would have had there been no bankruptcy." But there *was* a bankruptcy and the C&M bondholders were a part of it for at least 12 years, during which their rights were governed by Section 77. None of those rights was violated, and there can be no retroactive violation, by reason of their escape (if such be the case), entitling them to "compensation".

III.

The Rights of Choctaw & Memphis Bondholders Are Governed by the Federal Law, Namely, the Law Relating to Bankruptcy. Under That Law, the Bonds Are Not Entitled to Interest on Interest.

In their brief in the court below, respondents stated:

> "Since the proceeding below is based upon the bankruptcy law, the federal rule as to interest payment should apply. This would seem to be indicated by

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Prudence Corp. v. *Geist*, 316 U. S. 89 (1942), where the court, reviewing a proceeding under the Bankruptcy Act, rejected a rule of law which had been enunciated by the New York Court of Appeals in a state liquidation proceeding, precluding a holder of certain guaranteed certificates, who is also guarantor thereon, from participating in distributions until the other certificate holders were paid in full. The Supreme Court said (p. 95):

> 'Nothing decided in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, requires a court of bankruptcy to apply such a local rule governing the liquidation of insolvent estates. The bankruptcy act prescribes its own criteria for distribution to creditors. In the interpretation and application of federal statutes, federal not local law applies.' "

To show what respondents claim to be the applicable federal rule of law, they cited various decisions of this and other Federal courts that holders of interest coupons are entitled to receive interest thereon from their dates of maturity. But none of these cases involved bankruptcy, and the decisions do not purport to state the law applicable to bankruptcy proceedings. They involve solvent obligors whose failure to pay the interest arose from unwillingness and not inability to pay.

The Circuit Court of Appeals did not decide whether the principle of those cases was applicable in bankruptcy proceedings. Instead, the court said:

> "We believe, however, that federal decisions are of no binding effect here, but rather that under the doctrine of *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, where the bankruptcy court is charged with the duty of protecting a lien unaffected by bankruptcy, the law of the state of performance must control. • • • when it [the bankruptcy court] deals with the right of a citizen to enforce a lien under the state law, unaffected by bankruptcy • • • it must grant relief demanded by the laws of the state." (R. 251.)

In so stating, the court was following its theory that the Choctaw & Memphis bonds are not a part of the plan and have no part in the reorganization. Thus freeing itself from any considerations of federal law, the court held that "as determined by the State of Pennsylvania, the holders are entitled to simple interest on coupons after their maturity". If, as we contend and have shown under Point I, the Court's theory of "unaffected by bankruptcy" is erroneous, its conclusion that the law of Pennsylvania governs fails.

The holding of this Court in the *Prudence Corporation* case that *Erie R. Co.* v. *Tompkins* does not require a court of bankruptcy to apply local rules of law governing the liquidation of insolvent estates, has not been changed.

It should be noted that the C&M mortgage contains no covenant to pay interest on delayed or defaulted primary interest.* Therefore, the bondholders' claim is not based on contract. If valid, it must be based upon some general principle of law applicable in a bankruptcy proceeding. Respondents have cited no such case, and their failure to do so is good evidence that none exists.

Far from sanctioning interest on interest, the *general* rule under the Bankruptcy Act is that *no* interest is payable which accrues after the date of the filing of the petition in bankruptcy (Bankruptcy Act, 63a(1)).

One exception to this rule is that on a secured creditor's claim, simple interest accrues if the security is sufficient. (*Coder* v. *Arts*, 213 U. S. 223, 245.) The C&M bondholders have been given the benefit of this exception.

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* The mortgage affirmatively shows that it was not intended that interest on interest should be paid. The relevant clauses of the mortgage are set forth in Appendix hereto, p. 32.

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IV.

In Terms, the C&M Mortgage Secures Only the Principal of the Bonds and Simple Interest Thereon. Therefore, Interest on Interest Would Constitute at Most a General Unsecured Claim in Bankruptcy.

As shown by the relevant excerpts therefrom which are set forth in the Appendix, p. 32, the Choctaw & Memphis Mortgage specifically provides that it is given to secure only the principal and simple interest of the bonds. The Mortgage Trustee is given the right, upon entry into possession of the mortgaged property in the event of default in payment of interest, to apply the net income "to the payment of the interest in arrears" (R. 75), and in the event of sale to receive from the proceeds only the principal and simple interest, with the duty to pay over any surplus proceeds of sale to the mortgagor. (R. 78-79.)

The Sequestration Order (R. 20) excused all Mortgage Trustees from making any further demand or application for the enforcement of any lien or right in respect of earnings of the several mortgaged properties (R. 20-21) and provided that the rights of each Mortgage Trustee should be determined as if due demand or application had been made, etc. But the order further provided:

> "but nothing in this order shall be construed * * * as requiring the [bankruptcy] Trustees to pay over or earmark any of the same pending the further order of the Court." (R. 22.)

But in recognizing liens, the Sequestration Order does not purport to go further than the mortgage itself. Where the mortgage does not give a lien for interest on interest, the Sequestration Order does not.

It follows that if any penalty is to be exacted for non-

payment of the interest as it became due, the amount of the penalty is not secured by the mortgage which, by its express terms, states that it is given to secure only principal and simple interest. At most, therefore, such a penalty would be a contract implied in law representing only a general, unsecured claim against the Choctaw, Oklahoma and Gulf estate.

We submit that the C&M bonds are not entitled to any claim for interest on interest for the reasons heretofore given. But if that claim were to be recognized at all, it would constitute only a general, unsecured claim against the Choctaw, Oklahoma and Gulf estate.

Conclusion.

Petitioners respectfully submit that the decision of the Circuit Court of Appeals for the Seventh Circuit is erroneous; that the questions involved are of general importance in the administration of the Bankruptcy Act, and that it is in the public interest to have those questions determined by this Court.

August 31, 1946.

Respectfully submitted,

W. F. Peter and
Otis F. Glenn,
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APPENDIX.

The Bankruptcy Act, as Amended.

SEC. 77. REORGANIZATION OF RAILROADS ENGAGED IN INTERSTATE COMMERCE.—(a) Any railroad corporation may file a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization. * * * Any railroad corporation the majority of the capital stock of which having power to vote for the election of directors is owned, either directly or indirectly through an intervening medium, by any railroad corporation filing a petition as a debtor may file, with the court in which such other debtor has filed such a petition, and in the same proceeding, a petition, a copy of which shall also be filed at the same time with the Commission, stating that it is insolvent or unable to meet its debts as they mature, and that it desires to effect a reorganization in connection with, or as a part of the plan of reorganization of such other debtor; * * *

(b) A plan of reorganization within the meaning of this Section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such an

amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; (5) shall provide adequate means for the execution of the plan, which may include the transfer of any interest in or control of all or any part of the property of the debtor to another corporation or corporations, the merger or consolidation of the debtor with another corporation or corporations, the retention of all or any part of the property by the debtor, the sale of all or any part of the property of the debtor either subject to or free from any lien at not less than a fair upset price, the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein, the satisfaction or modification of any liens, indentures, or other similar interest, the curing or waiver of defaults, the extension of maturity dates of outstanding securities, the reduction in principal and/or rate of interest and alteration of other terms of such securities, the amendment of the charter of the debtor, and/or the issuance of securities of either the debtor or any such other corporation or corporations for cash, or in exchange for existing securities, or in satisfaction of claims or rights or for other appropriate purposes; and may deal with all or any part of the property of the debtor; may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section. * * *

* * * The term "creditors" shall include, for all purposes of this section all holders of claims of whatever character against the debtor or its property, whether or not such claims would otherwise constitute provable claims under this Act, including the holder of a claim under a contract executory in whole or in part including an unexpired lease.

The term "claims" includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character. * * *

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(c)(7) The judge shall promptly determine and fix a reasonable time within which the claims of creditors may be filed or evidenced and after which no claim not so filed or evidenced may participate except on order for cause shown, the manner in which such claims may be filed or evidenced and allowed, * * *

(c)(10) The judge may direct the debtor or the trustee or trustees to keep such records and accounts, in addition to the accounts prescribed by the Commission, as will permit of such a segregation and allocation, as the necessities of the case may require, of the earnings and expenses between and to the divisions and parts of the railroad or other property of the debtor which are separately subject to the liens of the various mortgages or deeds of trust, or are separately subject to lease, and may refer to the Commission for its recommendations after hearings thereon if the parties shall so request and/or the Commission determine necessary or desirable, as to the method or formula by which such segregation and allocation shall be made; and thereafter such segregation and allocation may be made at the expense of the debtor's estate.

(e) * * * The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) hereof, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such times as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided,* That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, * * * (b) that the interests of such class of stockholders will not be adversely and materially affected by the plan, * * *: *Provided further,* That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by

the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests.

(f) * * * Upon confirmation of the plan, the debtor and any other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and the control of the judge, the laws of any State or the decision or order of any State authority to the contrary notwithstanding. The property dealt with by the plan, when transferred and conveyed to the debtor or to the other corporation or corporations provided for by the plan, or when retained by the debtor pursuant to the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, and the debtor shall be discharged from its debts and liabilities, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the judge may require the trustee or trustees appointed hereunder, the debtor, any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may require the debtor to join in any such transfer or conveyance made by the trustee or trustees. * * *"

Choctaw & Memphis Mortgage.

The granting clause of the Mortgage states that it is given (R. 66):

> "for the purpose of securing the payment of the principal and interest of the said bonds when and as the same shall become due and payable according to the tenor and effect of the said bonds so to be made and executed, from time to time, for a sum not exceeding in the aggregate three million seven hundred and fifty thousand dollars, together with the interest that will

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accrue thereon (both the said principal and interest being payable in gold), and taxes upon the said principal and interest of said bonds".

The mortgage recites that the property is transferred to the Trustee

> "for the purpose of securing the payment of the principal and interest of the said bonds when and as the same shall become due and payable according to the tenor and effect of the said bonds." (R. 65.)

Then the mortgage authorizes the Trustee to enter into possession of the property in case of default in the payment of interest for three months and directs the Trustee to apply any net income

> "to the payment of the interest in arrears (if any), or which shall after such entry become due and payable on the bonds outstanding and secured hereby, in the order in which such interest shall become due." (R. 75.)

The mortgage provides (R. 77) that the Trustee may sell so much of the property as may

> "be sufficient to pay the amount due on such bonds then outstanding, for principal and interest, according to the terms thereof"

and then provides (R. 78-9) that the proceeds of the sale shall be applied

> "to the payment of the principal of such of said bonds as may be at that time outstanding, *and of the interest which shall have accrued upon the said principal up to that time, according to the tenor thereof,* without discrimination or preference as between principal and interest, but ratably to the aggregate amount of such principal and accrued interest; it being understood and hereby declared and agreed that such payment shall be made to the persons holding the bonds and coupons evidencing the right to such principal and interest, without discrimination or preference between them, *and if, after payment in full of all the said bonds, principal and interest, a surplus of the*

said proceeds of sale shall remain, the said Trustee shall pay over such surplus to the said company, its successors or assigns, or as any court of competent jurisdiction shall lawfully direct." [Italics inserted.]

Also the Trustee is authorized by the mortgage to bid on behalf of the holders of the Bonds only the amount due in accordance with the tenor thereof. That provision is as follows (R. 80):

"the Trustee under these presents for the time being may, in its discretion, and not otherwise, bid for, and if the same be obtainable at the price hereafter mentioned, purchase and acquire the property so offered for sale, in behalf of all the holders of bonds secured by this instrument, which shall then be outstanding, in proportion to the amount of said bonds, and of the overdue coupons thereunto belonging, by them respectively held: PROVIDED, HOWEVER, That nothing herein contained shall authorize the said Trustee to bid, on behalf of the holders of said bonds and coupons, *a sum exceeding the whole amount of said bonds then outstanding, with the interest thereon, according to the tenor thereof,* and the costs and expenses of such sale for the entire property then held upon the trusts of this indenture, or any amount reasonably proportionate thereto, for any part of the said property.

"And it is further agreed that the mortgage bonds and overdue coupons aforesaid shall be received in payment of the purchase money or any property sold by virtue hereof, as equivalent to so much in cash of the said purchase money as would be distributable and payable thereon." [Italics inserted.]

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